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CREDIT UNION

MAY 28 '14 AM11:07 BOARD

May 23, 2014

Mr. Gerard Poliquin
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

RE: COMMENTS ON PROPOSED PROMPT CORRECTIVE ACTION – RISK-BASED CAPITAL REGULATION

Dear Mr. Poliquin:

We are writing to comment on the risk-based capital proposal as approved by the National Credit Union Administration (NCUA) Board on January 23, 2014. Our industry is at a crossroads and careful consideration of the long-term impact of the proposed regulation is needed before proceeding. Thank you for the opportunity to comment and we look forward to continued meaningful dialogue with the agency on this proposal.

We agree with the need for a risk-based capital measurement system for credit unions. It should be noted; however, that under current NCUA regulations credit unions already have risk-based net worth (RBNW) requirements that have served the movement well. Credit Unions have successfully weathered the recent storm of the greatest recession since the depression under our current guidelines, and we emerged stronger than ever without any taxpayer assistance.

We also preface our comments by noting that Amplify FCU is "well-capitalized," both currently and under the NCUA risk-based capital (RBC) proposal. While we support risk-based capital requirements conceptually, we strongly disagree with the implementation of those new requirements as proposed by the agency. Enacting the regulation as currently proposed would have the unintended consequences of reducing the number of members we can serve and negatively impacting credit union earnings over time. The regulation, as proposed, would place unnecessary limits on our business model, our ability to serve our members, and our ability to sustain earnings. The long-term negative impact on earnings caused by these limits, in turn, would ultimately impact the share insurance fund; which is certainly counter to the intended purpose of the proposed RBC regulation.

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We do understand the agency's desire to gain parity on risk-based capital with other financial institution regulations. However, we contend that in order to have parity, NCUA must first start by calling on Congress seeking legislation to:

1) Reduce the current leverage ratio from 7% to align with other financial institution regulation, and

2) Provide supplemental capital for credit unions.

Once accomplished, the NCUA could then build risk-based capital requirements on a parity-driven foundation. The credit union industry already has higher capital standards. We already have extra risk-based capital over that of other financial institution regulations with a required 7% leverage ratio to be well capitalized. The unique nature of credit unions is evident in lower loss ratios over time in comparison to other financial institutions. Credit unions have demonstrated greater real-world success in managing through tough economic times. When considering capital requirements, this must be factored in as part of the equation. We struggle to understand the logic in the agency's approach, which results in a de facto tax on capital for credit unions.

As previously stated, to gain parity on risk-based capital with other financial institution regulations, we believe that the NCUA must call on Congress to reduce the current leverage ratio from 7% to align with other financial institution regulations and provide supplemental capital for credit unions. This would provide a parity-driven foundation from which to build risk-based capital requirements. Until a proper foundation risk-based capital foundation is built, we believe that the current risk-based net worth requirements will continue to serve the industry well.

This is our position. However, the balance of our commentary (below) is suggested improvements to the regulation as proposed.

COMMENTS AND IMPROVEMENT SUGGESTONS FOR THE PROPOSAL

GENERAL

A. MOVING TARGET FOR RISK MANAGEMENT – The proposal attempts to capture credit risk, interest rate risk, and concentration risk. This, however, results in inconsistencies in application of the proposal. The agency attempts to capture interest rate risk in investments, concentration risk in loans, and credit risk in cash, which then creates a moving target to manage. The proposal's approach to risk, intended to capture all of these risks in one simple model, actually creates an overly complex model. A simpler, more understandable solution is needed.

We suggest that a better alternative is that risk-based capital requirements focus specifically on credit risk. Credit risk, appropriately so, identifies the inherent default risk of a particular asset. Proper monitoring of interest rate risk and concentration risk requires a review of the whole balance sheet. The risk-based capital proposal looks only at the asset side of the balance sheet and completely ignores the liability side of the balance sheet, which is used to both fund and mitigate risks from the asset side. The agency should certainly review a credit unions' exposure to interest rate risk and concentration risk. However, this would best be accomplished through the exam and supervision process with a full balance sheet impact approach.

Basic financial management teaches us that you match long-term assets with long-term funding. The proposal addresses long-term assets in a detailed way – which is the longer they are, the riskier they are, and the higher the risk weighting, but what about the funding side? It is not inherently risky to have more long term assets, if those assets are also appropriately and equally matched with long term funding sources. We regularly perform a matched book analysis on our balance sheet and specifically target and match longer term assets with longer term funding sources thus creating a matched book and locked-in margin spreads. This approach has served us well over the years with above peer margins. The proposed regulation simplistically assigns higher risk weights for longer term assets, regardless of matched funding or management experience with longer term assets.

B. **EXAMINER AUTHORITY** – We strongly disagree that any single examiner should unilaterally and subjectively be able to require a credit union to maintain a capital requirement higher than that required by the regulation itself. The purpose of the proposed risk-based capital regulation, as we understand it, is to establish the "rules of the game" for both the regulator and the regulated. This authority vested in a single examiner, is simply unacceptable and should not be allowed. This arbitrary approach could potentially usurp the collective wisdom, judgment, and experience of credit union management and board teams.

C. **COMPLEX CREDIT UNIONS** – Defining complexity as credit unions with assets of $50 million and above is a very simplistic approach. This approach paints with a broad brush and will include credit unions whose balance sheet may be simply straight shares and car loans. A better approach, once again, would be based on actual balance sheet composition of particular assets and liabilities.

<u>NUMERATOR</u>

D. **ALLOWANCE FOR LOAN LOSS** – We agree with including the allowance for loan loss account in the numerator of the equation for risk-based capital. This account, by its very nature, is set up as a risk reserve for credit risk on the entire loan portfolio based on the history of each individual credit union. However, we do not agree with the proposed 1.25% cap on inclusion of this account. A reserve for loan losses is just that and should be included in the risk-based capital calculation at full balance. Inclusion of the entire balance is important especially if proposed FASB promulgations are passed that might require higher reserves for anticipated loan losses. If the NCUA is concerned about overfunded allowance accounts, then this issue should be addressed with individual credit unions during the examination process when looking at the adequacy of the allowance.

E. NCUSIF DEPOSIT – A credit union's deposit in the National Credit Union Share Insurance Fund (NCUSIF) should not be deducted from capital in the numerator for risk-based capital. This makes no logical sense. This approach has a disproportionately negative impact on a credit union's ratio as proposed. We strongly disagree with this deduction for the following reasons:

1. The NCUSIF deposit is not a component of capital on a credit union's balance sheet. It is an asset and should be risk-weighted accordingly in the denominator of the risk-based calculation;
2. The deposit is not a risky asset as it is backed by the full faith and credit of the US government; and
3. The deposit has been on our balance sheet since inception of the NCUSIF and has weathered many economic downturns, including the most recent "great recession."

F. GOODWILL TREATMENT – Like the NCUSIF deposit, goodwill is not a component of capital on our balance sheet and therefore, should not be deducted from capital in the numerator. This will also be a strong disincentive for credit unions to complete mergers, both strategic and economic. As such, this will ultimately exacerbate NCUSIF losses from failed credit unions. Successful credit unions will not want to take on struggling ones in the cooperative spirit due to the inherent goodwill risk penalty they will accrue from the acquisition. This unintended consequence should be given strong consideration. Failure to address this issue will cause more, not fewer, failures at a greater cost to the share insurance fund.

DENOMINATOR

As stated above, any risk-based capital requirements should focus specifically on credit risk. Credit risk, appropriately so, identifies the inherent default risk of a particular asset. Proper monitoring of interest rate risk and concentration risk requires a review of the whole balance sheet. The risk-based capital proposal looks only at the asset side of the balance sheet. NCUA should certainly review a credit unions' exposure to interest rate risk and concentration risk, but this should be accomplished through the exam and supervision process with a full balance sheet impact approach. This is our primary premise.

However, our comments (below) are specific to the risk weights assigned in the agency's proposal.

G. INVESTMENT WEIGHTS – The proposal assigns investment asset risk weights mostly by maturity buckets; thus, the primary focus is on interest rate risk (IRR). Risk weighting is completely determined by the length of the asset and the guaranty status of the issuer. As such, the investment risk weighting assignments are consistent with current regulation and acceptable.

However, the proposal calls for a 1250% risk weight for MBS investments that are "not understood" by management. We disagree with this risk weight. These investments should follow the same criteria as outlined in the proposal. In no case should a risk weight be greater than the highest weight for the actual investments. In this case that would be 150%. This proposed risk weight is problematic logistically too. How does the agency intend to evaluate management's understanding? This would need to be clearly defined. As proposed, this would again allow a single examiner to hold a credit union to a higher capital standard based on a subjective assessment of a credit unions' "understanding" of the investment. This provision has the potential to subjugate management's judgment and may ignore the due diligence performed on the investment and the actual investment performance.

H. **CORPORATE PAID-IN CAPITAL WEIGHTS** – The proposal assigns a risk weight of 200% on corporate paid-in capital which is too high. Paid-in capital is more appropriately weighted at 125%. This recognizes that the deposit is at risk, while also recognizing that risk is mitigated by the new capital standards for corporate credit unions.

I. **LOAN WEIGHTS** – Loan asset risk weights are generally assigned by percentage levels in asset categories, thus the focus is primarily on concentration risk. In general, we believe that the proposed risk weights on real estate and business lending may force credit unions to target the lowest yielding consumer loan market segments. This one-size-fits-all approach could limit service to members, slow industry growth, and take a gradual toll on industry profitability and therefore, the share insurance fund. Credit unions need to remain relevant to their members, and therefore should not cede real estate and business lending to other financial institutions. Credit unions have less relative losses than other financial institutions in the real estate and business lending areas (and overall too). We suggest that the agency capture this uniqueness of credit unions and reward credit unions in their risk weightings for their performance in these areas.

Comments specific to loan categories are listed below:

Real Estate Loans

First mortgage real estate loans should have a risk weight of .75 for all balances above 35% of assets. This would provide for two tiers instead of three as proposed. This would also be consistent with current RBNW requirements and take into consideration credit unions' performance in these categories.

Second lien real estate loans, in principle, should have a higher risk weighting than first liens from a credit risk standpoint. It should be noted that many home equity loans and home equity lines of credit are actually in a first lien position.

Also of note is that home equity laws in the State of Texas limit home equity lending to 80% loan to value (LTV) when combined with the first mortgage. This makes second lien home equity lending in Texas inherently less risky than the rest of the nation. The proposed regulation should account for this unique risk profile in home equity lending by state. Based on this, we suggest that all second lien lending be risk rated at 100% instead of the three tiers as proposed.

A major flaw in the real estate proposal is that the model does not take into account actual loan lives, the remaining mortgage lives, or prepayment speeds. For example, our 30-year mortgages average 7-9 years of actual lives; our 15-year mortgages average 5-7 years of actual lives; and our 15-year second mortgages average 2-3 years actual lives. However, there is no provision in the proposal for reconciling and aligning long-term loans to their actual lives. Consequently, a 30-year mortgage with one year remaining is deemed to have much more risk than a 5-year mortgage with four years remaining. Actual historical credit union loan performance should also be taken into consideration. Actual real world performance is more highly correlated with long term performance and risk management. However, the proposal's risk weighting approach makes no provision for that. Empirical data that shows increased losses with increased real estate lending should be provided by NCUA to justify the proposed higher risk weights. This information should be reviewed across all markets, regionally and more locally. And finally, the real estate proposal structure ignores the benefits of economies of scale and acquired lending expertise. The proposal assumes that risk management through portfolio size limits and higher risk weightings trumps scale and expertise benefits. We would contend that credit unions gain economies of scale and expertise in certain lending areas as their portfolios grow. Obviously, we agree that loan diversification is important for proper risk management, but proven management expertise and ability to efficiently scale should be recognized and rewarded.

Business Loans – With a current business lending cap of 12.25% of assets, a 100% risk-based capital requirement makes sense. Should the credit union business lending cap be raised to 27.5% as proposed in legislation, then the second tier risk rating of 150% is high. We would suggest that the business lending asset class be risk rated based on the specific type of business lending (i.e. C & I lending having a higher risk rating than straight real estate). Also, since business lending is a specialized area, it would be wise to consider a credit union's track record in this area, rather than enforcing a one-size-fits-all approach.

J. CUSO INVESTMENT WEIGHTS – CUSO investments should not be risk weighted at 250%. We have seen no empirical evidence that supports such a high risk weight. CUSO investments are strategic and marked to market. Higher risk weightings would also have the unintended consequence of stifling innovation and collaboration in our industry. This is one of the seven cooperative principles and credits unions cooperate through CUSOs to better serve their members. Therefore, the risk should be equal to the balance on the books at 100%. A CUSO investment, in any case, is not riskier than the highest risk-rated investment, which is at 150% for investments >10 years.

K. MORTGAGE SERVICING RIGHTS – Mortgage servicing rights (MSR) being risk-rated at 250% makes these assets, along with CUSO investments above, the riskiest assets on the balance sheet according to the proposed regulation. Again, we have seen no empirical evidence to support this risk weighting. In our opinion, these assets should be risk-rated based on the corresponding underlying first mortgage asset as we have previously recommended below:

i. <25% assets = .50

ii. >25% assets = .75

Note that the accounting method for MSR's (fair value and amortization) should not be treated with the same risk weighting. Amortization is a much more conservative accounting approach, and therefore should not merit a 250% risk weighting.

OTHER COMMENTS

L. SHORT IMPLEMENTATION PERIOD – The implementation timeframe of roughly eighteen months post final NCUA Board approval is far too short. Basel requirements for banks used a phased in approach and allowed up to five years for implementation. Credit union implementation of the proposed regulation - or the proposed regulation with revisions - will inherently change the business model of many credit unions and force major balance sheet restructuring and possibly reduced profitability. This proposed change, if rushed, will undoubtedly have an industry-wide chilling effect on member service and growth. This proposed change should, therefore, be accomplished over a reasonable period of time to insure uninterrupted service to our members and minimize unintended consequences to the industry. And, with a complex solution as proposed comes many unintended consequences. I would suggest a 3-5 year implementation period. This would be on par with the risk-based implementation of the Basel model in the banking industry and allow credit unions the proper lead time to reposition their balance sheets and business models accordingly.

M. INCENTIVES FOR PERFORMANCE – Finally, we believe there should be incentives or rewards for good performance. We encourage the agency to consider some of the following for credit unions that perform well: reduced model risk weightings, longer exam cycles, asset waivers, personal guaranty waivers, etc.

IN SUMMARY:

- We agree with the need for a risk-based capital measurement system for credit unions.
- We recommend that the current risk-based net worth regulatory requirements remain intact as they have served our industry well in protecting the safety and soundness of credit unions.
- We recommend that the NCUA's proposed risk-based capital regulation be withdrawn.
- We recommend that the NCUA call on Congress to seek legislation to create a parity driven foundation for a future risk-based capital regulation.
- We recommend that the NCUA work with credit unions in developing future risk-based capital rules.

We sincerely appreciate your time in reading our commentary. We know that you have to cull through many such letters, which is a tedious process. We trust that the NCUA will take our comments to heart in the spirit of our cooperative movement and we look forward to working with you in crafting a win-win solution on risk-based capital.

Respectfully,

Paul Trylko, President/CEO
Amplify Federal Credit Union

Willie Everett, Chairman of the Board
Amplify Federal Credit Union